

# Fair Market Rent

## The Importance of Fair Market Rent

1031

Knowledge



A 2013 Tax Court decision, [Adams v. Commissioner, T.C. Memo 2013-7](#), demonstrates the importance of a taxpayer receiving fair market rent when desiring to obtain the tax-deferral benefits of an IRC Section 1031 exchange. In *Adams*, the taxpayer exchanged into a replacement property that was rented to the taxpayer's son and family. The IRS challenged this exchange and claimed the property was considered a "family home" since the actual rent paid from the son to his father was considered slightly below market rent.

However, in *Adams*, the replacement property was in poor condition at the time of the taxpayer's exchange. The taxpayer's son had experience as a contractor and personally made extensive repairs to the property. The son also paid for the materials needed to perform the repairs. In addition, the taxpayer's son lived on the property for the next four years and continued to maintain and repair the property, picking up the costs of these repairs out-of-pocket.

The Tax Court determined that the rent received from the son, plus the value of the improvements made by the son, constituted fair market rent. Consequently, the Court ruled there was no bargain rent. This case highlights the importance of receiving fair market rent when renting a property to a family member.

### REVENUE PROCEDURE 2008-16

[Revenue Procedure 2008-16](#) provides a safe harbor for vacation homes held for investment and defines whether or not a dwelling unit qualifies as property held for productive use in a trade or business or for investment under §1031 of the Internal Revenue Code. In Revenue Procedure 2008-16, it is noted that the dwelling unit must be rented "at a fair rental." Later in Section 4 of this Revenue Procedure, "fair rental" is specifically defined as, "For the purposes of this revenue procedure, whether a dwelling unit is rented at a fair rental is determined based on all the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account."

The definition of this Revenue Procedure indicates that the IRS will look at all facts and circumstances of a particular 1031 exchange to ascertain whether or not fair market rent was received.

### PLANNING CONSIDERATIONS WHEN RENTING TO A FAMILY MEMBER

1. Rent at a rate that is comparable to other similar rental properties in the market.
2. Enter into a rental or lease agreement in the same manner as with any investment property tenant. If a longer term rental, make sure the relationship is solely that of a landlord and tenant; the rent received is appropriate to the local market; and, the terms of the rental agreement strictly construe the rights and responsibilities of the parties as a landlord and tenant.

### Compliments of:



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